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Dear Mr Harding and Ms Corea,

Re: ACCC preliminary view on LTRCM capital expenditure and operating expenditure for 2018-19 and issues for further consideration

Telstra welcomes the opportunity to comment on the ACCC's preliminary view on nbn co's long term revenue constraint methodology (LTRCM) capital expenditure and operating expenditure for 2018-19 and issues for further consultation.

We support the ACCC's position that nbn co should provide more transparency around financial outcomes in the enterprise market. It would be inappropriate for nbn co to cross subsidise its entry into the enterprise market. Thus, clarity is required to ensure nbn co is correctly categorising its costs.

Telstra believes the current SAU and LTRCM process is not fit-for-purpose because:

- The application of a commercial weighted average cost of capital (WACC) of over 6% is unreasonable since nbn co's expected internal rate of return is 3.2%;
- Social objectives have been prioritised as the NBN has been rolled out – the LTRCM therefore cannot assume that all nbn's costs have been incurred on a commercial basis;
- There is no transparency around which part of nbn co's activities are commercial and which are non-commercial; and
- Additional reporting requirements are necessary.

We discuss each of these aspects further below.

The application of a commercial WACC is unreasonable since nbn co's expected internal rate of return is lower than this

The SAU and LTRCM process are designed to provide a commercial return to a commercial business while constraining prices to prevent a monopoly operator charging unfair prices. Under the SAU, nbn co currently earns a regulatory WACC of over 6% on its assets, and similarly earns that return on revenue shortfalls (i.e. its initial cost recovery account (ICRA)). However, nbn co is not operating as a commercial business, as its forecast internal rate of return of 3.2% is well below its regulated WACC of 6.2% in 2019. Such a return would be unsustainable for a commercial business, so the LTRCM should not assume nbn co is operating as commercial business and able to recover a 6.2% return on its historical costs.

nbn co's rollout has prioritised social objectives

nbn co has prioritised underserved areas during its rollout of infrastructure, which tend to be higher cost regional and rural areas where there are fewer customers resulting in lower initial revenues. The decision to prioritise regional and rural areas was to meet a well-founded social policy objective. In contrast, rollouts of infrastructure in commercial sectors, such as mobiles, start in higher density areas and progress towards less dense areas over time. Rollouts are staged like this because the potential customer base in higher density areas is far higher which increases initial revenues, shortening investment payback periods and providing better cashflows for further investment.

The social policy decision for nbn co to prioritise lower density areas has resulted in lower revenues over the build period and a larger and increasing ICRA than otherwise would occur. The ICRA is designed to enable future recovery of capital costs accumulated during the build phase when revenues are low and costs high. It was envisioned that once the build was complete the ICRA could be paid back over time with an interest rate set at the WACC.

However, the uncommercial nature of the rollout compounded the size of the ICRA which accumulates interest at a commercial rate. Consequently, the ICRA will likely grow into perpetuity, rather than be a short term shortfall account as it was designed. If the LTRCM process is premised on nbn co making commercial and efficient investment decisions, then adjustments need to be made to the ICRA to account for nbn co's non-commercial objectives and associated spend.

There is no transparency around which parts of nbn co are commercial and which are non-commercial

The LTRCM process provides no information relating to the commercial and non-commercial objectives of nbn co. For a number of reasons, there should be increased transparency regarding nbn co's activities, including:

- nbn co is a competitor in the enterprise market – it would be inappropriate if nbn co relies on the LTRCM to cross subsidise its activities in the enterprise market;
- Some fixed line network operators will be required to pay the regional broadband scheme levy in order to subsidise nbn co's non-commercial fixed wireless and satellite services – it is inappropriate if competitors were funding nbn co's losses for non-commercial activities if nbn co's prices were not similarly providing for the subsidy.

Telstra supports the ACCC's view that increased transparency of nbn co's costs and entry into the enterprise market is necessary. nbn co has expanded into the enterprise market, which is already a highly competitive area. This raises concerns about the effect on private sector investment and a distortion of competition in the market. Further scrutiny and transparency is necessary to ensure effective competition in the market which is in the long-term interests of end users.

Additional reporting requirements are necessary

In light of the transparency concerns above, Telstra believes segment level reporting by technology type and customer type is necessary. This will provide transparency regarding commercial and non-commercial activities and where potential cross subsidies exist. Importantly, greater transparency could provide assurance to nbn co's competitors in the enterprise market that its entry is commercial and efficient, and its entry is not being cross subsidised by its consumer and small business activities. The Appendix includes items Telstra believes are required to improve transparency.

If further clarification is required, please contact Ben Hutchinson on 03 8694 4051, or ben.hutchinson@team.telstra.com.

Yours sincerely,

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Appendix – Items that should form part of the transparency requirements

Capital expenditure, operating expenditure, revenues and appropriate profitability measures (operating margin/EBIT, EBITDA, ICRA Payoff forecast), by:

- residential and enterprise;
- product – unbundled (e.g. this would include AVC and CVC so we can understand the efficiency of NBN's bundling activities);
- technology type; and
- geographic areas (e.g. those profitable vs non-profitable geographic areas to identify whether and to what extent, there is a cross subsidy).

The ACCC should also receive:

- 'building block' cost components for each category (e.g. residential and enterprise); and
- details of direct and indirect (shared) costs for each category (e.g. residential and enterprise).

Any cost allocation should be in accordance with a published cost allocation methodology approved by the ACCC.